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UNCLAS SECTION 01 OF 03 SHANGHAI 000679

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SUBJECT: SHANGHAI STOCK EXCHANGE UP 300 PERCENT IN TWO YEARS

REF: A. SHANGHAI 534

¶B. SHANGHAI 133
¶C. SHANGHAI 325
¶D. SHANGHAI 251

SHANGHAI 00000679 001.2 OF 003

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¶1. (SBU) Summary: The Shanghai Stock Exchange Composite Index topped 6,000 points on October 15 bringing gains over the past two years up to 300 percent. This growth is "good" according to a Shanghai Stock Exchange (SSE) official and the government should not attempt to set limits on where the index should be. Instead, the government should promote new products, laws and regulatory oversight that protect the interests of investors. Legal protections for investors are weak. Concerns about how to protect retail investors from losses mean that the Tianjin-Hong Kong "Fast Train" investment plan is on hold, but short selling, margin trading, and a stock index futures product will be introduced soon. The SSE will not be interested in swapping equity with the Hong Kong exchange until it is privatized, but it is also being courted by other international exchanges. Non-Chinese companies that might want to issue a primary or secondary listing on the SSE will need to wait until competing Chinese agencies agree on a legal framework and China's foreign exchange controls are lifted. End summary.

¶2. (SBU) Shanghai Stock Exchange (SSE) Assistant to the President Dr. Que Bo, noting that the Shanghai Composite Index closed over 6,000 points for the first time on October 15, told Econoff on October 19 that the SSE's management has been "surprised" at the 300 percent increase in the market over the last two years (ref A). "Over the past two years many things have been unexpected. We expect more unexpected things to happen in the future," he said. According to Que, all this growth is "good" and the government should be happy to see the markets going up. While there have been official government media stories talking down the markets, as happened in February

and June (refs B & C), the SSE thinks that the government should not interfere with the market to maintain a certain index level. Instead, the government should focus on promoting better legal and regulatory infrastructure and encourage new products such as futures, short selling and margin trading in order to better protect investors.

A Share-H Share Swap?

¶3. (SBU) Que said that China Security Regulatory Commission (CSRC) Vice Chairman Tu Guangshao's widely-reported October 17 remarks that CSRC was considering permitting the exchange of mainland-listed A shares and Hong Kong-listed H shares had been "completely misunderstood" by reporters. Que clarified that CSRC's Tu had been referring to a swap of equity between the Hong Kong and Shanghai Stock Exchanges. This swap of equity was an "unilateral wish" on behalf of the Hong Kong stock exchange since the SSE has neither the ability nor the desire to swap equity with any stock exchange at this point. The Hong Kong government is afraid that with international exchanges buying each other up, the same thing might happen to their exchange. As a result, they are trying to "pre-empt" this from happening by buying up enough of the Hong Kong exchange so that "the Japanese Stock Exchange couldn't own it."

SSE's Dance Card is Full

¶4. (SBU) While the SSE was ignored by the world's exchanges for its first 15 years, in the past year it has been heavily courted by stock exchanges from around the world, including NYSE, NASDAQ, London, Nikkei. They are all interested in partnering with and acquiring some of the SSE. The SSE, however, is still government-owned. While most SSE staff would like to see it privatized, it will be "5-15 years" before the regulators feel comfortable enough to let this happen. The SSE needs to improve its own management capabilities, human resources, and bring

itself up to international standards before this will take place.

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Tianjin-Hong Kong 'Fast Train' -- Off the Tracks?
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¶5. (SBU) Que said that the much-ballyhooed Tianjin Bank of China - Hong Kong "Fast Train" proposal to allow Mainland investors to purchase stocks on their own accounts on the Hong Kong stock exchange is not likely to happen anytime soon. Recent success of new Qualified Domestic Institutional Investor (QDII) products that invest in Hong Kong and elsewhere have accomplished the goal of starting to move money out of China in a way that looks safer to the regulators than letting retail investors make their own decisions about stocks in Hong Kong. Que expects more delays and backtracking on this issue before it is finally derailed over regulatory discomfort with the risks involved to individual investors.

Short selling -- In Place Soon

¶6. (SBU) Regulatory approval to allow Chinese investors to engage in short selling of stocks "will definitely be in place soon, possibly by the end of this year." Que said that both the SSE and stock brokerages are "technically ready" to handle short selling. The decision on timing will be made by the CSRC who are apparently concerned that they do not understand the effects that short selling will have on the market. The CSRC hopes to time their decision so that it would "not destabilize the markets." Que added that margin selling is another innovation that will be introduced after the markets have adjusted to the expected launch of the stock index futures product.

The Futures Is Also "Soon"

¶7. (SBU) Que dismissed rumors that the stock index futures product could be launched as early as November, saying State Council approval is necessary and they are not ready to give it. He said that while the China Financial Futures Exchange (CFFEX) is ready to launch its first product -- a stock index future -- it is not likely to happen until the beginning of next year (Ref D). (Note: Mutual fund managers tell Econoff that not having this index fund hurts their ability to hedge risks and keep up with the market. The Chinese government is concerned that a stock index future product would destabilize the markets further. End note.)

Regulatory & Legal Framework: Implementation is Weak

¶8. (SBU) Protecting investors continues to be one of the SSE's major goals. Que said that the SSE's Surveillance Department is "incredibly busy" with daily reports about insider trading and other irregularities. While all of these tips and complaints are sent to the CSRC for further investigation, most are not investigated since the CSRC lacks the staff to follow through. China has lots of laws and regulations designed to protect investors, but its implementation of these laws is weak. China's legal structure contributes to this weakness since it does not depend on case law for precedents. Each case is decided by the courts based on their own interpretation of the law. The markets have grown and changed too rapidly for judges to keep up with those changes, said Que. Last year some investors tried to sue a company for violating their rights -- the case was not accepted by a judge on the basis that investors had never sued a company in China before.

Overseas Companies Listing in China

¶9. (SBU) There is currently only one non-Chinese company listed on the SSE -- a Japanese company. The SSE would be very pleased

to have other non-Chinese companies list and in fact has been talking with Mercedes-Benz about listing since 1993. Que said that recently both HSBC and Siemens have expressed interest in a secondary-listing on the SSE. However there are significant regulatory and legal hurdles that need to be overcome by the CSRC, the Ministry of Commerce, and the State Administration of Foreign Exchange. Que did not think it likely that these problems could be overcome in the near future -- especially given the context of China's capital controls.
JARRETT